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BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, D.C. 20554

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JUL 1 1994

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

In the Matter of	)	
	)	FCC 94-39
Implementation of Sections of the	)	
Cable Television Consumer Protection	)	MM Docket No. 93-215
and Competition Act of 1992	)	
	)	CS Docket No. 94-28
and	)	
	)	
Adoption of a Uniform Accounting	)	
System for Provision of Regulated	)	
Cable Service	)	

COMMENTS OF TURNER BROADCASTING SYSTEM, INC.

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July 1, 1994

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Summary

Turner Broadcasting System, Inc. ("TBS") comments are directed at one aspect of the Commission's cost-based cable rate regulation, the treatment of affliate transactions. The Commission would be best served by retaining the current prevailing price rule for affiliate transactions.

The FNPRM's proposal was not developed to solve a problem currently existing in the markplace; the proposal would establish a prophylactic rule that will irreparably harm affiliated cable networks, like TBS. However, as these Comments and the economic studies submitted herein demonstrate, the hypothesized problem underlying the proposal does not exist in virtually all circumstances and is premised on a fundamental fallacy. As such, adoption of the proposal would be unlawful.

Any analogy to the treatment of affliated transactions for telephone companies is misguided. The businesses are quite different. The fact that advertising-supported networks like TBS' exist in virtually every available home belies completely the assertion in the FRNPRM that these services do not have "a predominate purpose of serving non-affliates."

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COMMENTS OF TURNER BROADCASTING SYSTEM, INC.

Turner Broadcasting System, Inc. ("TBS"), by its attorneys, hereby files its comments in the above-captioned proceeding. TBS's comments are directed at one aspect of the Commission's cost-based cable rate regulation, the treatment of affiliate transactions.[1] The FNPRM proposes additional rules to restrict the ability of cable systems to recover costs associated with carriage of affiliated programmer networks like the TBS networks. These restrictions would apply both to cost-of-service regulation and to the cable operator's ability to pass through external costs under the benchmark regulations.

Under the existing rules, when a cable operator buys from an affiliate, the operator may pass through or utilize the price charged if it is the programmer's "prevailing company price," i.e., if the programmer has sold its service to a substantial number of third parties at a generally available price.

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[1] Further Notice of Proposed Rulemaking ("FNPRM") at ¶¶ 309-313.

However, the FNPRM proposes an important and substantial change. It states that "we propose that any non-cable affiliate that sells less than 75% of its output to a non-affiliate has too large a volume of affiliate transactions to be deemed to have a predominate purpose of serving non-affiliates" (FNPRM, ¶ 311). In such circumstances, the proposed rules would require cable systems to value affiliated programming at the lower of the programmer's net cost and fair market value.

This proposal was not developed to solve a problem existing currently in the marketplace. Instead, having created the benchmark rate regulation and cost-of-service schemes, the FNPRM hypothesizes that there exists a regulatory incentive, which heretofore would not be present, for cable operators to "game the system" and increase their programming costs in order to increase their price to consumers. Although the Commission has ample authority under the 1992 Cable Act to prevent and sanction evasions of rate regulation,[2/] the FNPRM establishes a prophylactic rule that will irreparably harm affiliated cable networks. As is discussed below, and demonstrated in the reports prepared by Professor Michael Salinger of Boston University and submitted with these comments,[3/] this

[2/]47 U.S.C. § 623(h).

[3/]"The Effect of a 'Prevailing Price' Rule for Affiliate Transactions Under Price Regulation," by Professor Michael Salinger (Exhibit A hereto). "The Likely Effect of the FCC's Proposed Rule for Affiliate Transactions Under Price Regulation," by Professor Michael A. Salinger (Exhibit B hereto). Professor Salinger's statement of qualifications is attached as Exhibit C.

hypothesized incentive does not exist in virtually all circumstances.[4] In short, as Professor Salinger concludes, the "proposed rules are premised on a fundamental fallacy."[5] As a solution to a problem that does not exist, the proposal is inappropriate and unlawful.

Yet even while the proposed rules are pending, they are inflicting harm on affiliated networks in this newly created regulatory environment. The proposed rules create a strong incentive for cable systems to offer affiliated services a la carte, as opposed to on a regulated tier. They may, in the final analysis, even incent companies to sever the vertical relationship between them. The Commission has authority under the 1992 Cable Act to force the divestiture of vertical relationships -- and the Commission has declined to do so. To the contrary, the Commission and Congress have recognized in many contexts the value of vertical integration in the cable industry and that vertical integration has led to increases in diversity in programming. Recognizing that value, the Commission has endorsed greater approval of vertical integration for the broadcast industry in the video marketplace.

It would be particularly ironic if this proposal led to a reduction in the number of vertically integrated networks or adversely affecting their quality, since under the statutory scheme created by the 1992 Cable Act, only this category of networks are made available under the program access rules to provide the foundation of competition to cable.

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[4] Certainly, there is the hypothetical risk that a cable operator will create something like the "Time of Day Network," which might consist of a camera perpetually focused on a clock, and charge itself a hefty subscription fee for carriage. But as Professor Salinger concludes, the FNPRM's solution to this problem is too wide-ranging and "too heavy-handed." Exhibit B at 16.

[5] Exhibit A at 23.

Finally, the assumption that in the FNPRM that these rules should be parallel to the treatment of affiliated transactions for telephone companies[6], upon analysis, makes no sense. The businesses of a telephone company and a cable network are quite different. For an advertising-supported business like the basic cable network business, the economic incentive is to maximize distribution to sell advertising, not maximizing distribution revenue. That overriding economic truth is underscored by the fact that CNN, TNT, and TBS Superstation, as well as other affiliated programmers, are sold to every willing customer. The fact that these services exist in virtually every MMDS, SMATV and TVRO home and will be in virtually every DBS home belies completely the FNPRM's assertion that these services do not have "a predominate purpose of serving non-affiliates."

The remainder of these comments will demonstrate these points.

1. Congress and the Commission Recognize the Contribution to Diversity Through Vertical Integration

We start with the assumption that the affiliated transaction proposal is not a policy attempt by the Commission to deliberately disadvantage or remove any incentive for vertical integration in the cable industry. To the contrary, it is abundantly clear that both Congress, when it enacted the 1992 Cable Act, and the Commission in thus far administering the Act, have recognized the value of vertical integration and have disclaimed any intention to undo it. Moreover, such a course would stand in stark contrast with the Commission's recognition in the broadcast area that vertical integration is in the public interest.

[6] FNPRM at ¶ 310.

First of all, from the very beginning in the congressional debate that led to the 1992 Cable Act, Congress has recognized the positive effects of vertical integration in the cable industry. For example, the 1991 Report of the Senate Committee on Commerce, Science and Transportation regarding S.12 invoked the testimony that

> ...there are benefits to vertical integration... "the primary way it has been a good thing in the cable industry is that vertical integration has been the means by which we have stimulated the development of programming that was necessary to flesh out the promise of cable, the promise of our medium when nobody else was really willing to step up and put up the money."[7]

The Report then explicitly rejected any prohibition of vertical integration. Rather, it stated that the asserted anticompetitive effects of such integration should be addressed by simply "ensuring competitive dealings between programmers and cable operators and between programmers and competing video distributors."[8]

The 1992 Report of the House Committee on Energy and Commerce to accompany H.R. 4850 states in a similar vein that

> ...information forwarded to the Committee indicates that some concerns about discrimination against rival programming services may be overstated. A 1988 National Telecommunications and Information Administration (NTIA) study stated that "common ownership of cable systems and cable programming services does not appear to affect adversely the supply of cable programming or the diversity of viewing choices for cable subscribers." NTIA found that none of the top five multisystem operators...showed a pattern of favoring basic services with which they were affiliated. Other witnesses before the Committee testified that vertical relationships strongly promote diversity and make the creation of innovative, and risky, programming services possible. These witnesses point to C-Span, CNN, Black Entertainment Television, Nickelodeon, and the Discovery Channel as examples of innovative

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[7] S. Rep. No. 102-92, 102d Cong., 1st Sess., 26, 27 (1991) (quoting and citing Testimony of James Mooney (NCTA), "Oversight of Cable TV," 178-79).

[8] Id. at 27.

> programming services that would not have been feasible without the financial support of cable system operators.[9]

Thus, the 1992 Cable Act does not outlaw vertical integration prospectively or require the divestiture of any vertical relationship in the industry. Instead, the 1992 Cable Act adopted behavioral provisions to promote competition and diversity between distributors of video programming through Section 19 of the 1992 Cable Act, 47 U.S.C. § 628, and by directing the Commission to prescribe reasonable limits on the number of channels on a cable system that can be occupied by a video programmer in which a cable operator has an attributable interest. 47 U.S.C. § 533(f)(1)(B). Furthermore, the Act directed the Commission to prevent a cable operator from requiring a financial interest in a program service in order to obtain carriage or coercing a programmer to provide exclusive rights. 47 U.S.C. § 616.

The Commission succinctly summarized the benefits of vertical integration in a proceeding implementing the 1992 Cable Act:

> Congress and the Commission have both recognized that there are benefits which result from vertical integration. First, [Multiple Service Operator (MSO)] investment has produced a wealth of high quality cable programming services. Many of the most popular cable programming services were initiated or sustained with the help of MSO investment. Second, vertical integration between cable operators and video programming services appears to produce efficiencies in the distribution, marketing, and purchase of programming. Third, vertical integration can reduce programming costs, which in turn may reduce subscriber fees and cable rates. Fourth, vertical integration may in certain circumstances foster investment in more innovative and riskier video programming services.

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[9] H.R. Rep. No. 102-628, 102d Cong., 2d Sess. 41 (1992). Moreover, the Additional Views of Messrs, Ritter, Tauzin, Slattery, Kostmayer, Oxley, and Fields state that "...vertical integration of cable systems has led to a diversity of program offerings which had previously been unknown,..." H.R. Rep. No. 102-628 at 173. Additional Views of Messrs. Ritter, Tauzin, Slattery, Kostmayer, Oxley, and Fields.

Report and Order, 8 FCC Rcd 8565, 8594-95 in MM Docket No. 92-264, FCC 93-456, released Oct. 22, 1993.

The 1992 Cable Act also gave the Commission standby authority to sever existing vertical integration between programmers and distributors. 47 U.S.C. § 533(f)(1)(C). In the proceeding addressing this section, the Commission expressly declined to utilize its authority to require divestiture. The Commission refused to impose restrictions on the "ability of multichannel distributors to engage in the creation or production of video programming" because

> [i]n view of the structural and behavioral restrictions already required under the 1992 Act, we do not believe that additional restrictions on the ability of multichannel distributors to engage in the creation or production of video programming are warranted at the present time.

Id. at 8608. The Commission recognized that

> [i]n adopting Section 11 of the 1992 Cable Act, Congress also recognized that certain benefits derive from vertical integration and horizontal concentration. For example, the House Report acknowledges that vertical relationships promote program diversity and make the creation of new and innovative programming services possible. Further, the House Report suggests that vertical relationships may be an efficient way of financing new programming services and compensating cable operators for assuming some of the risk associated with the launch of new cable programming services.

Id. at 8568.

The Commission has further recognized the positive attributes of vertical integration in the steps it has taken in modifying its longstanding financial interest and syndication rules applicable to broadcast television networks. The Commission, and the courts reviewing the Commission's work, have recognized that allowing integration between distributors and program producers permit economies of scale, allow producers to shift risks to larger, more diversified entities (i.e., the networks) who are presumptively better able to bear it, and thereby increase diversity.[10] Other recent developments, such as Fox's investment in New World Communications, further demonstrate that the marketplace recognizes the value of vertical integration.

2. Vertical Integration has Affirmatively Assisted TBS's Contribution to Diversity and Competition

It would be particularly inappropriate to penalize companies such as TBS who have been at the center of the growth of diversity and consumer choice and who have utilized cable investor capital to reach these goals. As the Commission is well aware, for over 20 years, TBS has sought to enhance consumer choice and competition by developing a wide range of programming alternatives. These contributions include the various types of specialized sports, informational and entertainment programming envisioned by the earliest observers of the cable industry. TBS's programming services, which are distributed by cable operators, as well as by alternate technologies, include TBS Superstation, Turner Network Television, Cable News Network, Headline News, the Cartoon Network and Turner Classic Movies. TBS will launch CNN International in the United States in January 1995. TBS is also a partial owner and the operator of SportSouth, a regional sports network.

TBS's success in launching and sustaining its networks has resulted from its ability to purchase programming and program rights, to expend the costs necessary to produce original

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[10] See Shurz Communications, Inc. v. FCC, 942 F.2d 1043, 1046-47 (7th Cir. 1992); Report and Order, 6 FCC Rcd 3094 (Rel. May 29, 1991). See also Tentative Decision and Request for Further Comments, 94 FCC 2d 1019 (1983).

programming, and to gain access to delivery systems providing wide distribution, as well as from its willingness to endure losses in order to ultimately achieve success, and to obtain investment capital from MSOs. In 1986, TBS paid approximately $1.4 billion for the MGM film library and extensive rights to the Warner Bros. and RKO libraries. And more recently, TBS purchased Hanna-Barbera with its library of cartoons, as well as its production company. The Turner libraries, now housed in our Turner Entertainment Company subsidiary, collectively comprise one of the largest feature film libraries in the world, with over 3300 motion pictures and 1700 hours of television programming. TBS has recently completed its acquisition of NewLine Cinema and Castle Rock Entertainment.

TBS views purchases of this nature as crucial to its survival, to its ability to solidify the financial health of its networks, and to its ability to continue to offer innovative programming. Given the importance of these purchases, TBS was therefore willing in 1986 to finance the MGM acquisition with what amounted to short-term "bridge" financing and to seek financial support from MSOs. Until long-term financing could be obtained, the Company's independence was very much at stake. To restructure this short-term debt, in June, 1987, TBS sold a minority interest (36% of equity and 16% of voting shares) to a group of more than two dozen cable industry investors. The two most substantial investors were Time, Inc. with 11.5% of equity and Telecommunications, Inc. ("TCI") with 8.0% of equity. TBS Chairman Ted Turner retained 51% of equity and 68% voting control. The cable investors were guaranteed seven seats on the fifteen member TBS board. A "supermajority" of 12 board members is required to approve certain matters, including major financial questions.[11]

TBS selected this cable investor group because the group was prepared to provide long-term equity while preserving the Company's independence. While the operators' investments have proved more than sound, at the time the operators were perceived as taking a major risk, one that others would not undertake at comparable terms.

It is readily apparent why these cable operators were willing, more than other potential investors, to take risks in order to support TBS. The success of these cable systems is closely linked to the attractiveness of cable programming; the potential benefit to their core business gave the operators an incentive that others did not have to make what was a relatively risky investment in programming ventures. This incentive, moreover, can be seen operating not just in TBS but also with other networks such as BET, The Family Channel, MTV, VH-1, Nickelodeon, the Comedy Channel, Bravo, CNBC and others, in addition to a number of pay networks.

The adoption of the affiliate sales proposal will punish programmers such as TBS, The Family Channel, BET, and others for having taken advantage of their best sources of risk capital and therefore of the ability to develop programming designed to cater to the needs of specialized viewers. Under the <u>FNPRM</u>'s proposal, since TCI by itself is affiliated with nearly 25% of the available subscribers, TBS and other programmers will clearly be subject to these Draconian rules. Moreover, while in the telephone application of the rules,

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[11]Ted Turner retains voting control today. TCI and the merged Time-Warner, Inc. nonetheless would both be affiliates of TBS under the <u>FNPRM</u>'s proposal.

a telco affiliate could increase its sales to non-affiliates and escape the imposition of the rules, TBS and other affected programmers, many of whom are nearly universally distributed, have no escape hatch available.

3. The Hypothesized Problem is Unlikely to Occur in the Real World

The affiliate sales proposal is not a reaction to a practice currently existing in the cable marketplace. In fact, since advertising-supported cable networks derive approximately one-half of their revenue from advertising,[12] the networks' primary incentive is to price these services in such a way to maximize distribution in order to capture the maximum advertising revenue. That is why cable networks such as CNN, TBS Superstation, ESPN, USA, TNT and MTV, whether vertically integrated or not, have achieved virtually universal distribution in the multichannel marketplace.

It is these incentives that prompt the TBS rate cards, which are technology-neutral, to offer volume discounts to capture customers. As a consequence, TCI and Time Warner, the two largest cable operators in the country, obtain the lowest price under the volume discount structure, the exact opposite of the hypothetical concern. Now, because of a hypothetical regulatory incentive under benchmark and cost-of-service regulation, the FNPRM is concerned that TCI and Time Warner will now seek higher prices from TBS in order to capture more revenue at the operator level.

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[12] Paul Kagan Associates, Inc., CABLE TV PROGRAMMING, March 23, 1993, at pp. 6-7.

We asked Professor Salinger to rigorously test this hypothesis through economic analysis. His report, "The Effect of a Prevailing Price Rule for Affiliate Transactions Under Price Regulation" (Exhibit A), demonstrates the lack of a credible economic base for the hypothesis, except in very narrow circumstances, if at all. As Professor Salinger indicates, the "proposed rules are premised on a fundamental fallacy. They presume that a cable operator with a share in a cable network would care just as much about the network's profits as its own."[13/] To the contrary, Professor Salinger's paper concludes that the current regulation -- a prevailing price rule -- provide incentives to lower prices even where the network is vertically integrated. Professor Salinger indicates that the FNPRM's proposal mistakenly focuses on the share of output sold to affiliates, whereas the key factor is the share of the networks owned by the affiliates. Even without considering the advertising factor, "a prevailing price rule is likely to provide an incentive to lower the price of a network if the cable operator's share of the network is less than 62% and may provide an opportunity for an ownership share as high as 95%."[14/] When advertising is taken into account, "a greater ownership share will be needed for a prevailing price rule to provide incentive to increase ownership of the network." Thus, economic analysis provides no support for the proposal, and in fact, undercuts it.[15/]

As Professor Salinger's other report, "The Likely Effect of the FCC's Proposed Rule for Affiliate Transactions Under Price Regulation" (Exhibit B), concludes, the rule creates a

[13/]Exhibit A at 23.

[14/]Exhibit A at 2.

[15/]The hypothetical concern is certainly even more remote in the case of a company like TBS, who has a single-majority shareholder -- Ted Turner -- not a cable operator.

clear bias against vertical integration and imposes a substantial cost on networks and operators who are integrated. Hence, instead of solving a problem, the rule merely penalizes vertical integration where Congress and the Commission have otherwise decided that doing so is inappropriate.

The inevitable impact of this rule will be to create a strong incentive for cable systems to offer affiliated services a la carte where they may recover fully their costs, as opposed to selling them on the regular tier. By so doing, such a step would inevitably negatively impact the cable system's distribution, eventually adversely affecting the network's advertising revenues,[16] cash flow and quality. This is an astounding harm to inflict in order to plug a hypothetical loophole. It is doubly ironic because under the statutory scheme created in Section 19 of the 1992 Cable Act, 47 U.S.C. § 628, only vertically integrated cable networks are required to be made available under the program access rules to provide the foundation to cable's competitors. It is hardly coincidental, we submit, that ESPN, exempt from Section 19, has strong elements of exclusivity, and FX -- a creation of Section 6 of the 1992 Cable Act -- is being sold on a cable exclusive basis.

Finally, establishment of the proposed rule in the telephone context does not require it to carry over here. The FNPRM contains no reasoning as to applying the proposed telephone company charges to cable operators as well. There are major differences, for example, between vendors affiliated with telephone companies and cable program networks who depend on advertisers for revenue. As Professor Salinger recognizes: "Advertising

[16] Cable networks reaching less than 40 million households are able to obtain markedly lower prices per actual viewer than more widely-distributed networks can demand.

and, in particular, the way advertising is priced, provides a cable network with an incentive to keep its subscription prices low enough so that all cable systems carry it."[17] In contrast to the situation with telephone affiliates who can pursue other opportunities to increase output to non-affiliates, it would be impossible for companies like TBS, Discovery and others, who are already in every cable household, to overcome the 25% trigger.

4. Adoption of the Proposal is Not Only Unwise, but Contrary to Law

But not only is the FNPRM's proposal unnecessary and contrary to economic analysis, as such, its adoption would be legally improper. It is a fundamental tenet of administrative law that a regulation "perfectly reasonable and appropriate in the face of the given problem may be highly capricious if the problem does not exist." Alltell v. FCC, 838 F.2d 551, 561 (D.C. Cir. 1988); HBO v. FCC, 567 F.2d 9, 36 (D.C. Cir.), cert. denied, 434 U.S. 829 (1976). Accord Turner Broadcasting System, Inc. v. FCC, __ U.S. __ (No. 93-44, June 27, 1994) (Slip. Op. at 41.). As the Commission itself has acknowledged in applying the principle established in HBO: "a government regulation that is unnecessary cannot be justified." In the Matter of Amendment of Part 90 of the Commission's Rules Pertaining to End User and Mobile Licensing Information, Notice of Proposed Rulemaking, 7 FCC Rcd 2879 (1992) (citing Home Box Office, 567 F.2d at 36).

Where, as here, the rule assumes behavior that makes no economic sense, no problem requiring regulatory intervention can be assumed. The Supreme Court has made that point quite clear in the context of the antitrust laws, see, e.g., Matsushita Elec. Indus. Co. v.

[17] Exhibit A at 2; see also, id. at 18-22.

Zenith Radio Corp., 475 U.S. 574, 597 (1986). And in view of Professor Salinger's studies, the Commission cannot conclude, consistent with its obligations under administrative law, that it must -- or even should -- act.

Here is a case where if the Commission imposed such a rule now, it would again have "failed to 'put itself into a position to know' whether the problem that its regulation [sought] to sole 'was' a real or fanciful threat." Century Communications Corp. v. FCC, 835 F.2d 292, 305 (D.C. Cir. 1987), quoting Quincy Cable TV, Inc. v. FCC, 768 F.2d 1434 (D.C. Cir. 1985), cert. denied, sub nom. National Association of Broadcasters v. Quincy Cable TV, Inc., 476 U.S. 1169 (1986). While a court would overturn the adoption of this rule, in the interval consumer welfare and diversity would suffer.

CONCLUSION

The Commission would be best served by retaining the current prevailing price rule. It can deal with situations, like our fanciful "Time of Day Network," by utilizing the authority to police evasions in the rate regulation scheme. Only if experience demonstrates a concrete need for sterner measures, should the Commission revisit its prevailing price regulation.

Respectfully submitted,

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The Effect of a "Prevailing Price" Rule for Affiliate Transactions Under Price Regulation

Michael A. Salinger
June, 1994

I

Introduction

In its Notice of Proposed Rulemaking "In the Matter of Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992: Rate Regulation" (MM Docket No. 93-215) and "Adoption of a Uniform Accounting System for Provision of Regulated Cable Service," (CS Docket No. 94-28), the FCC has proposed a set of rules governing the effect of subscriber fees charged by cable networks to "affiliated" cable systems on the maximum price a cable system can charge its customers. Under the proposal, a "prevailing price rule" would govern affiliate transactions when less than 25% of a network's sales are to affiliates. When more than 25% of a network's sales are to affiliates, then the affiliate transactions are treated as occurring at the lesser of cost and fair market value. As is discussed in a companion paper, this alternative to the "prevailing price rule" is administratively more difficult; and it provides a disincentive for cable operators to invest in programming. The rationale for limiting the use of the prevailing price rule is the concern that it would provide an incentive to increase prices (of cable networks and, in turn, basic cable service). This paper demonstrates that a prevailing price rule provides an incentive to *lower* prices under a much broader set of circumstances than those under which the rule would be applied under the current proposal. As a result, the Commission should broaden the conditions for the prevailing price rule to apply.

The remainder of the paper is organized as follows. Section II describes the elements of the proposed rules that are fundamental to the analysis in this paper. Section III then analyzes the rules under the simplifying assumptions that only one cable operator is affiliated with the network, that the network obtains all of its revenue from subscription fees, and that cable operators are allowed to pass through their programming costs into cable rates on a dollar for dollar basis. Under these assumptions, a prevailing price rule is likely to provide an incentive to lower the price of the network if the cable operator's ownership share of the network is less than 65% and may provide an incentive to lower prices for an ownership share as high as 96%. In fact, cable operators are allowed to add a 7.5% margin to their programming prices. Section IV incorporates this additional factor into the analysis and shows that its effect is small. Taking the 7.5% mark-up into account, a prevailing price rule is likely to provide an incentive to lower the price of the network if the cable operator's ownership share of the network is less than 62% and may provide an incentive to lower prices for an ownership share as high as 95%. Section V extends the analysis to cases in which more than one operator has an ownership share. Even if the sum of their shares exceeds 62%, some of the affiliates might have an interest in reducing the price of the network. The shares of these operators should be ignored in calculating whether the share of cable operators is high enough for a prevailing price standard to provide perverse incentives.

No analysis of the economics of basic cable networks is complete if it does not take account of the role of advertising. Such an omission would be similar to an analysis of major league sports that ignored television revenues or an analysis of local telephone networks that ignored the provision of access to long distance networks. Section VI incorporates advertising into the analysis. Advertising and, in particular, the way advertising is priced, provides a cable network with an incentive to keep its subscription prices low enough so that all cable systems carry it. Price increases cause all businesses to lose customers, but such increases are particularly costly for a cable network. Not only would it lose the subscription fees and advertising revenues from any systems that drop it, it would also face a reduction in the price it receives for advertising to its remaining subscribers. While this effect is difficult to quantify, it is likely to be substantial particularly for networks that have virtually universal coverage. Even when a single cable operator owns 100% of a cable network, it might be reluctant to take advantage of a prevailing price rule for affiliate transactions.

Section VII discusses the implications of the results. It argues that the conditions under which a prevailing price rule would apply should depend on two factors: the ownership share of cable operators in the network and the fraction of sales to affiliates. The simplest rule that would take account of both would be to allow a prevailing price rule when the sum of those two shares is less than some critical value. In my judgment, the appropriate cut-off would be 150%.

II

Key Elements of the Proposed Rules

The FCC allows cable operators to choose between two alternative approaches to regulating cable rates: a benchmark-based price cap or a cost-based price cap. The rules governing affiliate transactions are relevant for both approaches. Under the first approach, increases in programming costs can be passed through (with a 7.5% mark-up) into basic prices. Under the second, programming costs (along with a 7.5% mark-up) are an allowed cost. The opportunity to pass programming costs through into cable rates raises the concern that vertically integrated operators will use the price of programming to circumvent the FCC's price regulations. This concern is the rationale for having a set of rules governing affiliate transactions.

In the cable industry, it is common for one or more cable operators to own part of a cable network. Thus, some standard is needed for what constitutes vertical integration or, "affiliation." The proposed standard is that a cable operator with at least a 5% share in a cable network is an "affiliate."

It is also common for cable networks that are partially owned by one or more cable operators to sell to cable operators with no ownership interest. One relatively simple standard for treating affiliate transactions is a "prevailing price" rule. Under such a standard, a cable network must charge affiliated cable operators the same price it charges unaffiliated cable operators. The FCC's requirements that a vertically integrated cable network be made available to all parties on comparable terms makes this standard easier to implement. This rule against price discrimination eliminates much of the ambiguity that might arise in determining what the price charged to non-affiliates is.

The intuitive appeal of a "prevailing price" rule, other than the ease of implementation, is that prices charged to non-affiliates might seem to be a good proxy for the prices that would prevail if the cable network were independent of cable operators. This rationale is not, however, strictly correct. The existence of a prevailing price rule alters the network/cable operator's incentives in setting the price to non-affiliates.

In the NPR, the FCC proposes to allow the prevailing price rule only when less than 25% of a cable network's output is sold to affiliates.[1] When more than 25% of a cable

[1] The regulations are not clear on whether the standard is 25% of subscriber fees or 25% of total revenues, including advertising revenue.